

DCI Notes
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BUSINESS COUNCIL

Anti-inflation theme

Two clear messages

1. Don't expect to solve in short run

But optimistic economy is working its way out of problem

2. Concern whatever program is produced preserve your credibility - most essential element in dollar's stabilization

Specifically hope you'll not overstate the potential of guidelines, tax income based policies, or whatever to reduce inflation in near term, but recognize they're useful steps in a longer battle

S E C R E T

T A B C

Maurice Ernst
D/OER
ER - Jim Patton

Following is a text of a report on the U.S. economy presented to The Business Council on October 13, 1978 by Irving S. Shapiro, Chairman, E.I. duPont de Nemours & Co.

Report on the Current State of the U.S. Economy and Outlook
As Seen By the Technical Consultants To The Business Council

The views of our economists on the outlook for 1979 are not as easy to summarize today as they have been previously. We have their numbers for 1979, based on a survey taken in early September, but these don't tell the whole story. The statistical forecast suggests that our consultants are in basic agreement on the outlook for 1979, which they are in one sense, but statistical averages for the full year can cover up different quarterly patterns of growth as well as the view of those who are either considerably more optimistic or more pessimistic than the majority.

Based on the survey results, our consultants would agree on the following aspects of the outlook:

First, the economy will grow more slowly next year than this year. Their median forecast is for a rise of 3% in real GNP for 1979, versus an expected 3.8% gain this year. These numbers are lower than those in their April survey, but this should not be interpreted as meaning they are more pessimistic about the outlook today than they were in April. They are anticipating about the same relative slowdown in growth between 1978 and 1979 as they were in April, but have lowered their growth expectation for 1978 from 4.3% to 3.8%. Only one consultant anticipates faster growth next year than this year.

Second, there will be no recession in 1979, that is, there will not be two consecutive quarters of declining real growth.

Third, inflation will remain a very serious problem next year. This median forecast is for a rise of 7.4% in the Consumer Price Index next year, essentially the same as this year's expected 7.5% rise. In April, they were anticipating a rise of 6.4% in the CPI for 1978 and 6.6% in 1979, and that forecast was substantially above their January forecast. In the eight months since the January survey, the consultants have boosted their inflation forecast for both 1978 and 1979 a full 1½ percentage points.

Other key points from the survey are as follows, again keeping in mind that the variation around the averages may be fairly wide:

- * The strongest sector of the economy next year will be in the capital spending area, specifically outlays for non residential structures. The consultants' median forecast projects a rise of 7.1% in these outlays in real terms. This is the only sector where they currently are forecasting a greater rise for 1979 than they were in 1978.

- * The weakest sector of the economy next year will be residential construction, primarily single-family housing. Their median forecast is for a decline of 6.3% in real outlays for residential construction, although two consultants anticipate a continued rise in construction expenditures next year. Higher interest rates and reduced savings flows will be responsible for the decline.
- * The consultants expect corporate profits to rise 4.4% next year, following a strong 11.7% gain this year. However, two consultants anticipate a small decline in corporate profits next year.
- * The unemployment rate is forecast to increase slightly next year, to 6.4% from 6.1% this year. In April, the consultants forecast that the unemployment rate would remain unchanged next year at 6.2%.

Beneath these areas of broad general agreement, our consultants are widely split on the pattern of growth to be expected during 1979. Somewhat more than half expect growth to be slower in the first half than the second half, but a significant minority expect a stronger first half than second half. Within this latter group, two consultants expect real GNP to reach a cyclical peak in the third quarter and one anticipates no growth between the third and fourth quarters.

These quite diverse quarterly patterns can yield virtually identical averages for 1979, but if they are projected to 1980, the differences become much more apparent and much more important. The majority view of a stronger second half leads logically to a somewhat higher rate of real growth in 1980 than in 1979, whereas the minority view suggests that growth in 1980 will be less than in 1979, including the possibility of a recession. No specific quantitative forecasts of 1980 were made by our consultants, but informal discussions with them on this point since their meeting indicate that these inferences about their views on 1980 are correct.

The reasoning supporting the case for a slow first half of 1979 is that the many negative factors already prevalent in the economy -- high interest rates, a decline in savings flows to thrift institutions, a slowdown in the growth of real incomes, a high ratio of installment debt to disposable income, etc. -- will adversely affect new housing activity and consumer spending this fall and early next year rather than later in 1979.

Those who hold this view do not expect the forthcoming declines in these sectors to be long or deep because there are no obvious excesses to be corrected. The housing industry, in particular, has strong underlying support from demographic trends as well as the belief that real estate is a good inflation hedge.

This group also expects capital spending to be expanding throughout 1979. The leading indicators for capital spending are as strong today as they were a year ago.

The pickup in growth anticipated for the second half of 1979 by the majority will reflect a bottoming-out of the relatively mild slowdown in housing and consumer spending and continued growth in capital spending. In short, the majority view is for a six-to-nine month "rolling adjustment."

The reasoning behind the minority view of a stronger first half than second half is that the current momentum of growth will carry well into 1979 until additional monetary restraint forces a decline in the credit-sensitive sectors. They expect the decline brought on by higher interest rates to extend into 1980.

Thus there is a genuine division of opinion on the outlook despite the agreement on the numbers for calendar 1979. Such a split in views is not unusual at this stage of an economic expansion, but it clearly complicates business planning for 1979 and 1980, and it does not help those who must shape government economic policy at this critical time.

With regard to the current thrust of government economic policy, a big majority of our consultants believes that monetary policy is too easy today and that further restraint would be appropriate. They recognize that sharply higher interest rates could cause a recession, but most believe that the economy is strong enough currently to withstand some additional restraint. Moreover, they believe that the risk must be taken in the hope that it will help moderate inflation as well as provide support for the dollar.

On the matter of fiscal policy, most of our consultants do not favor a tax cut at this time which would stimulate demand, that is, would increase the deficit. A tax cut for this reason would be inconsistent with their belief that further monetary restraint is needed to fight inflation.

Virtually all of our consultants favor tax reduction coupled with a lower level of government spending. They are deeply concerned about the heavy burden of government on the economy and the lack of tax incentives to stimulate capital investment and improve productivity.

With regard to the immediate problem of how to deal with inflation, our consultants reject short-term palliatives and strongly prefer a longer term approach that deals with fundamentals. They recommend meaningful reductions in the federal deficit, a tax program designed to raise productivity, a gradual slowing in the rate of growth of the monetary aggregates, a slower rate of real economic growth, and concrete actions by government to relieve inflationary pressures caused by government, such as the higher minimum wage, agricultural subsidies, and regulations that cannot be justified on a cost-benefit basis. President Carter's veto of the Public Works Bill was one such action.

They point out it has taken more than a decade to reach our present 7% or 8% underlying rate of inflation and that this problem will not be solved quickly. They recognize that the Administration must deal with the inflationary psychology that exists in the country today, but they fear that programs developed in response to immediate pressures could do more harm than good by generating expectations that cannot be fulfilled.

Accordingly, they are not enthusiastic about guidelines or any of the tax-based incomes policy proposals (TIP). They doubt that guidelines can be held in the face of large federal deficits and continued rapid growth of the money supply, and they fear that if the guideline approach should fail, the Administration would be pushed further toward direct controls, even though the President has expressed his reluctance to travel that route, absent a national emergency.

They believe that any tax-based incomes policy would be administratively unworkable, and they oppose the idea in principle as an undesirable intrusion of government into the pricing process. They feel that once we start such a program, we probably never would get rid of it.

Some of the fears of our consultants would be ameliorated if, in conjunction with announcing a guidelines policy telling industry and labor what is expected of them, the Administration announced, with specificity, the actions it intends to take in the fiscal-monetary-structural area. In their view, it is government policy in these areas that should be the main focus of the anti-inflation battle. President Carter took such an approach in his April 1977 speech on inflation, but his statements were not followed up in his subsequent budget proposals or his actions with regard to the minimum wage, social security, farm prices supports, etc.

A key element in any long-range program to reduce inflation must be to achieve a slower rather than a faster rate of real economic growth. Our consultants believe that this can be done without boosting unemployment. They report that the economy is operating today very close to its true full employment potential -- despite the nominal 6% unemployment rate -- and that the underlying growth rate of the economy from this point forward is likely to be closer to 3% than the 3.3% to 3.8% rate assumed by the Council of Economic Advisors. Their views are based on the operating rates they observe in their own industries, the record-high ratio of persons with jobs to the working-age population, the relatively slow growth of capital spending and capacity, and the pronounced slowdown in the rate of productivity growth.

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In this context, they view the prospect of a slackening in growth next year as a positive rather than a negative development. Some industries may experience more problems than they would like as the overall rate of growth eases but, in view of our consultants, the total economy cannot grow any faster than 3% from its present level without creating new strains, more inflation, and ultimately a full-fledged recession. This is why they do not advocate tax cuts without equivalent spending cuts at this time and why they oppose legislation such as the Humphrey-Hawkins Bill that has faster growth as its objective.

In summary, if the majority view of our consultants turns out to be right, it would mean that the economy is making a successful transition to a slower more sustainable rate of growth without the pain of a recession. Federal Reserve monetary policy is contributing to this slowdown, and so far has avoided causing a recession. Most of our consultants think this will continue to be the case. In time, slower growth should dampen inflationary pressures, but the problem is that it may not happen soon enough for those who must face the voters on this issue.